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Planning the Tax Consequences of Partnership Agreements, Funded with Life Insurance, to Provide for Disposition of a Deceased Partner's Interest

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battery the jury was not allowed to consider the mitigating circumstances and defendant was convicted of second degree murder.

III. Conclusion

The fact of an actual battery is not important under the circumstances presented in the *Brookshire* case. Whether or not deceased brushed or pushed defendant before the latter turned and fled bears little relation to the fear engendered. The importance lies in the threatening words and conduct of deceased which placed defendant, however reasonably, in fear for his very life. It was in this state of mind that defendant whirled and shot deceased. At that moment was defendant capable of, and did he in fact kill with, malice? This is a question of fact and must be answered by the jury upon proper instructions.

Hopefully, at its next opportunity the Missouri Supreme Court will do away with the arbitrary battery requirement for adequate provocation. Reason, and an understanding of the motivating forces in men would seem to call for its abolition.

Lee E. Stanford

PLANNING THE TAX CONSEQUENCES OF PARTNERSHIP AGREEMENTS, FUNDED WITH LIFE INSURANCE, TO PROVIDE FOR DISPOSITION OF A DECEASED PARTNER'S INTEREST

Although "the best laid schemes o'mice and men Gang aft a-gley; An'lea'e us nought but grief and pain, For promised joy"[1] planning should nevertheless not be abandoned. Well conceived plans, for example, are particularly essential when partners face the problem of what will happen to the partnership after the death of one partner.[2] This article will discuss the federal income and estate tax consequences of various kinds of partnership agreements designed to provide for the orderly disposition of a partner's interest in the partnership upon his death, and the tax consequences of funding such agreements with life insurance. The term "partnership agreement" as used herein includes provisions in a buy-sell agreement[3] or an insurance contract, as well as a partnership agreement.

For federal income tax purposes, "Generally, the valuation placed by the partner's upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct."[4] The valuation of the partnership interest fixed in the partnership agreement will also be accepted for estate tax purposes if

1. Robert Burns, *To a Mouse,* Stanza 7.
2. Unless otherwise indicated, the discussion herein will be directed to a partnership with two members, although the same principles would be involved in a partnership with three or more members.
3. For some of the historical development of the buy-sell agreement, see Kamens & Ancier, *Further Victories for the Buy-and-Sell Agreements,* 10 J. Am. Soc'y C.L.U. 211 (1956).
4. Treas. Reg. § 1.736-1(b)(1) (1956).

the agreement (1) is enforceable under state law[5] and supported by "full and adequate consideration in money or money's worth";[6] (2) is a bona fide transaction and not a gift or testamentary transaction;[7] (3) restricts the disposition of the partnership interest during life;[8] and (4) restricts the disposition of the partnership interest after death.[9]

The restriction upon the disposition of the partnership interest during life can be a right of first refusal[10] or an option to purchase.[11] The restriction on disposition after death can be an option to purchase,[12] an obligation to offer to sell,[13] or a mandatory contract requiring the estate of the decedent to sell and the surviving partner to buy.[14] However, a right of first refusal is not a sufficient after-death restriction upon disposition.[15] In this article it will be assumed that each of these requirements for an effective partnership agreement has been satisfied.

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5. Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Estate of May v. Commissioner, 194 F.2d 396 (2d Cir. 1952); Estate of Lomb v. Commissioner, 82 F.2d 166 (2d Cir. 1936); Estate of Wilson v. Commissioner, 57 F.2d 682 (2d Cir. 1932); Estate of Lionel Weil, 22 T.C. 1267 (1954), *acq.*, 1955-2 CUM. BULL. 10; Estate of Harry W. Hammond, 13 CCH Tax Ct. Mem. 903 (1954), *supplemental opinion*, 14 CCH Tax Ct. Mem. 83 (1955); see Annot., 73 A.L.R. 983 (1931).

6. Estate of Armstrong v. Commissioner, 146 F.2d 457, 460 (7th Cir. 1944); Treas. Reg. § 20.2031-2(h) (1958).

"The adequacy of the consideration must be measured at the time the contract was entered into rather than at the time the option was exercised." Edith M. Bensel, 36 B.T.A. 246, 253, *aff'd*, 100 F.2d 639 (3rd Cir. 1938).

Reciprocal agreements are considered "full and adequate consideration." Estate of May v. Commissioner, *supra* note 5; Estate of Lomb v. Commissioner, *supra* note 5; Estate of Wilson v. Commissioner, *supra* note 5; Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938), *acq.*, 1938-1 CUM. BULL. 20.

7. Estate of Armstrong v. Commissioner, *supra* note 6; Commissioner v. Bensel, 100 F.2d 639 (3rd Cir. 1938); Estate of Orville R. Littick, 31 T.C. 181 (1958), *acq.*, 1959-2 CUM. BULL. 5; Treas. Reg. § 20.2031-2(h) (1958); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 244.

8. Claire Giannini Hoffman, 2 T.C. 1160 (1943), *acq.*, 1944 CUM. BULL. 11, *aff'd sub. nom.*, Gianninni v. Commissioner, 148 F.2d 285 (9th Cir. 1945), *cert. denied*, 326 U.S. 730 (1945).

9. Treas. Reg. § 20.2031-2(h) (1958); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237; Rev. Rul. 54-76, 1954-1 CUM. BULL. 114.

10. Brodrick v. Gore, *supra* note 5; Estate of May v. Commissioner, *supra* note 5; Estate of Lomb v. Commissioner, *supra* note 5; Estate of Wilson v. Commissioner, *supra* note 5; Estate of Albert L. Salt, 17 T.C. 92 (1959), *acq.*, 1952-1 CUM. BULL. 4. The right of first refusal must apply to all dispositions, not just to dispositions to outsiders. Krauss v. United States, 140 F.2d 510 (5th Cir. 1944).

11. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 243; Rev. Rul. 54-76, 1954-1 CUM. BULL. 194.

12. Estate of May v. Commissioner, *supra* note 5; Estate of Wilson v. Commissioner, *supra* note 5; Estate of Nicolo Fiorito, 33 T.C. 440 (1959), *acq.*, 1960-1 CUM. BULL. 4.

13. Estate of Lomb v. Commissioner, *supra* note 5; Estate of Albert L. Salt, *supra* note 10.

14. Brodrick v. Gore, *supra* note 5; Estate of Lionel Weil, *supra* note 5; Estate of John T. H. Mitchell, *supra* note 6.

15. Estate of Smith v. Commissioner, 134 F.2d 578 (1st Cir. 1943); Estate of Ambrose Fry, 9 T.C. 503 (1947), *acq.*, 1948-2 CUM. BULL. 2; Estate of F. A. Koch, 28 B.T.A. 363 (1933); Estate of Richard B. Messer, 27 B.T.A. 556 (1933),

I. VALUING THE PARTNERSHIP INTEREST

One of the most difficult problems in drafting the partnership agreement is the method[16] of valuing the partnership.[17] The following are some methods which have been used.

A. *Book Value*

The book value of the partner's interest in the partnership is the amount in his capital account adjusted to reflect his share of the earnings or the losses of the current period.[18] An advantage of the book value method is that it is simple; however, there are disadvantages[19] arising because the dollar amount of book value is influenced by the different methods of depreciation (such as straight line, double declining balance or sum of the years digits), different methods of valuing inventory (such as LIFO, FIFO or average cost), different bookkeeping methods (such as cash basis, accrual basis or hybrid cash and accrual), failure to record appreciation in tangible assets, and failure to record intangibles such as good will. Book value may be so unrealistic under the given circumstances that specific performance will be denied,[20] although partnership agreements calling for the use of book value as the purchase price will usually be upheld in state courts.[21]

B. *Agreed Price*

Under this method the partners agree upon a dollar amount as the value of the partnership interest. Although this method appears simple, it may be difficult

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acq., XII-1 CUM. BULL. 8; Estate of George H. Walker, 23 B.T.A. 663 (1931), *acq.*, X-1 CUM. BULL. 2.

16. The partnership agreement is a contract and must state the purchase price or some way of arriving at it. This section is concerned with the "method" which will be employed in the partnership agreement. For discussion pertaining to what should be considered in valuing the business interest, see, Sircliffe, *Valuation of a Business Interest,* 7 J. AM. SOC'Y C.L.U. 293 (1953). The "method" which is used is apparently of no concern to the Commissioner. Treas. Reg. § 1.736-1(b)(3) (1956).

17. See generally WILLIS, PARTNERSHIP TAXATION 404-09 (1957); Currie, *Buy and Sell Agreements with Respect to Corporate and Partnership Interests,* 1950 WIS. L. REV. 12, 18-20; Forster, *Valuing a Business Interest for the Purpose of a Purchase and Sale Agreement,* 4 STAN. L. REV. 325 (1952); Forster and Willis, *How to Draft a Partnership Buy and Sell Agreement,* 8 U. So. CAL. 1956 TAX. INST. 57, 59-66; Note, 71 HARV. L. REV. 687, 690-91 (1958).

18. The partnership agreement should specify the date upon which book value will be determined. If the last closing date previous to the death of the partner is selected, then withdrawals made by the partner between that time and his death are not taken into account. If the book value on the date of death is chosen, a special closing of the books will be required if the partner does not die at the end of a regular accounting period. If the book value at the end of the accounting period in which the partner died is used, it is imperative that such things as depreciation, changes in inventory, reserves for taxes, insurance and other end-of-the-year expenses are properly allocated to each accounting period.

19. Block, *Book Value Pitfalls in Buy-Sell Agreements,* 95 TRUSTS & ESTATES 408 (1956).

20. Egan v. Wirth, 26 R.I. 363, 58 Atl. 987 (1904).

21. Annot., 47 A.L.R.2d 1425 (1956).

to reach an agreement on the dollar amount; furthermore, the partners often fail to keep the agreement up-to-date by periodic redeterminations of the worth of the partnership. Also, this method often fails to take into consideration withdrawals of assets by the partners.

These disadvantages can be overcome to some extent by providing first, for a periodic redetermination of value and a right to demand independent appraisal in the event there has not been a redetermination, and second, that withdrawals from a partner's capital account will decrease the agreed price for his interest in the partnership.

Advantages of the agreed price method are the lack of dispute as to value, virtual certainty as to validity,[22] and knowledge of the amount of insurance which is needed to fund the agreement in full.

C. *Appraisal or Arbitration*

The partnership agreement may provide for independent appraisal or for arbitration of the worth of the partnership at the time of death. The main disadvantages of this method are expense, time and selection of the appraiser or arbitrator. Also standards probably should be provided for the appraiser or arbitrator, for example should inventories be valued at cost, market, or lower of cost or market, and what factors should be taken into consideration in appraising good will. Furthermore, there is great uncertainty as to the amount of life insurance needed to fund such an agreement, since prior determination of the exact

Under state law, contracts which call for determination of price by appraisal or arbitration may or may not be enforceable.[23]

amount of the price is impossible.

D. *Capitalization*

Under this method the partnership agreement would provide that earnings for some stated length of time prior to the partner's death would be capitalized at a stated rate to determine the worth of the partnership. In a service partnership with few assets the capitalization of earnings may give the most accurate picture of the value of the partnership. Earnings should be computed after a deduction for the salaries of the partners.

At one time the Internal Revenue Service approved of valuing intangibles by capitalization.[24] However, the Service subsequently held that for purposes of estate tax valuation such a formula would not be approved in every case.[25] But there is little reason to suppose that a capitalization formula used in a partnership agreement to fix the value of the partnership, including intangibles, would be attacked by the Comissioner, since capitalization is a common method of valuing and no attack by the Commissioner has been found.

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22. Annot., 73 A.L.R. 983, 984-85, 991-92 (1931).
23. Annot., 117 A.L.R. 1095 (1935); 5 WILLISTON, CONTRACTS 1421 n.3 (rev. ed. 1937).
24. A.R.M. 34, 2 CUM. BULL. 31 (1920).
25. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 243; Rev. Rul. 54-77, 1954-1 CUM. BULL. 187, 193.

E. *Combinations*

The use of various combinations of the four methods previously discussed is frequent and, in fact, is usually necessary to obtain a fair determination of the partnership value. The following are some possible combinations: (1) Book value adjusted by an agreed amount for appreciation and good will; (2) Agreed price adjusted by fluctuations in book value; (3) Book value adjusted by appraisal of certain properties and perhaps also an appraisal of good will; (4) Book value of assets plus capitalization of earnings in excess of a certain rate of return on the book value.

To avoid litigation concerning the value of the partnership, the agreement should expressly state how good will and insurance owned by the partnership are to be handled. If the partnership agreement provides that there is no good will when in fact there is, the agreement may be disregarded for the purposes of state inheritance taxes,[26] even if it is still binding for federal tax purposes.[27]

II. FUNDING WITH LIFE INSURANCE

If the partners decide to fund their partnership agreement, life insurance on the life of each partner is the most obvious and widely used method.[28] Basically there are three ways in which life insurance is used:

A Cross Purchase Plan under which the usual method is to have each partner purchase and pay the premiums on a policy on the life of the other partner, payable to himself. Other less popular methods are for each partner to purchase and pay premiums on a policy on his own life payable to himself or his estate or wife, or for each partner to purchase and pay premiums on a policy on the life of the other partner payable to the other partner or other partner's estate or wife and have the partnership agreement provide that the proceeds from such policy shall be considered as coming from the surviving partner in payment for the deceased partner's interest.

An Entity Plan under which the partnership owns an insurance policy on each partner and the partnership agreement provides that the partnership shall purchase the deceased partner's interest with the life insurance proceeds furnishing part or all of the funds.

A Trust Plan results from the addition of a trust to either a Cross Purchase or Entity Plan. The insurance policies are assigned to a trustee who also receives the proceeds. The trustee pays the proceeds to the estate for the deceased partner's interest, which is transferred to the trustee. Then the trustee transfers the interest to the partnership or to the surviving partner, depending upon the terms of the agreement. The trust may be funded from its inception, but the usual procedure is for either the partners or the partnership to pay the premiums on the policies held by the trustee.

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26. Annot., 144 A.L.R. 1134, 1141-43 (1943).
27. Forster, *Valuing a Business Interest for the Purposes of a Purchase and Sale Agreement*, 4 STAN. L. REV. 325, 343-44 n.39 (1952).
28. A partner or a partnership has an "insurable interest" in a partner. 29 AM. JUR. *Insurance* § 487 (1960); Annot., 70 A.L.R.2d 577 (1960).

III. Tax Considerations

The Internal Revenue Code[29] allows the partners a considerable amount of freedom in determining the tax consequences which arise at a partner's death. They may choose a capital transaction under the cross purchase plan, or they may use an entity plan which can result in an ordinary income transaction, at least to some extent, or they may use a trust in conjunction with either of the two plans. When planning the partnership agreement, therefore, it is essential that the partners determine whether they want an ordinary income or a capital transaction or if they want some intermediate arrangement.

A. *Tax Considerations Under the Cross Purchase Plan*

1. Estate Tax

If partners A and B have policies on each other's life and B dies, B's estate will not include the proceeds from the policy on his life, which is held by A, because B has no "incidents of ownership."[30] The Commissioner has said:

> Where a business associate purchased a policy of insurance on the life of the decedent for the purpose of purchasing the latter's share in the business enterprise, naming himself, his executors, administrators, or assigns as beneficiary, paying all premiums thereon and retaining all incidents of ownership therein until the decedent's death, the proceeds thereof are not includible in the decedent's gross estate even though, at the same time and for the same purpose, the decedent may have purchased a similar policy of insurance on the life of the business associate.[31]

The Commissioner has also said that the reciprocal trust doctrine,[32] under which each partner would be deemed to own the policy which insures his life would not be applied to this arrangement. However, there will be included in B's gross estate the value of the unmatured policy on the life of A.[33] B's gross estate will also include the value of his interest in the partnership.[34]

If A instead of making himself the beneficiary of the policy which he took out on B, makes B's estate the beneficiary, then only the higher the value of B's interest in the partnership or the insurance proceeds will be included in his gross estate, if the partnership agreement states that the insurance proceeds are in payment for B's interest in the partnerhip.[35]

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29. Unless otherwise indicated, all references to "the Code" or to certain sections are to the Internal Revenue Code of 1954.

30. Int. Rev. Code of 1954, § 2042, 2033. Also see Estate of Lionel Weil, *supra* note 3; Estate of Henry A. Maddock, 16 T.C. 324 (1951), *acq.*, 1951-2 Cum. Bull. 3; Estate of John T. H. Mitchell, *supra* note 7.

31. Rev. Rul. 56-397, 1956-2 Cum. Bull. 599.

32. The reciprocal trust doctrine was established in the case of Lehman v. Commissioner, 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940).

33. Rev. Rul. 56-397, *supra* note 31.

34. Int. Rev. Code of 1954, § 2033. The interest will be valued in accordance with Treas. Reg. §§ 20.2031-3, 20.2031-2(h) (1958).

35. Memorandum for the Press from the Public Relations Division of the Treasury Department, November 24, 1947.

2. Income Tax

The premiums on the life insurance policies will not be deductible whether A owns a policy on B, payable to himself,[36] or a policy on himself, payable to B.[37]

Under the usual cross purchase plan, the proceeds of the life insurance policy will not be included in the gross income of the recipient.[38]

At one time the "transferee for value rule"[39] caused partners much trouble when they used the cross purchase plan. The transferee of an insurance policy who paid valuable consideration was only allowed a deduction from gross income of the amount of consideration he paid for the policy and subsequent premium payments while the rest of the proceeds were included in his gross income. However, the Code now expressly excepts transfers to partners and partnerships from the operation of the "transferee for value rule."[40] Therefore, existing policies which are owned by the individual partners may be transferred to each other to provide for the initial funding of a cross purchase plan, and also the policies may be transferred to the partnership at some future time in order to change to an entity plan, or the policies may be transferred from the partnership to the partners to change to a cross purchase plan. Also this special exemption from the operation of the "transferee for value rule" should allow the surviving partner to purchase the deceased partner's policy on the surviving partner without adverse income tax consequences.

A transfer of the deceased partner's interest under the cross purchase plan is a sale of an interest in a partnership resulting in a capital transaction subject to the provisions of section 741 while transfers of a deceased partner's interest under the entity plan are liquidations of the deceased partner's interest which may result in an ordinary income transaction subject to the provisions of section 736. Recent cases[41] indicate that the important factors which distinguish sales from liquidations are: (1) Who is obligated to buy the deceased partner's interest,

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36. INT. REV. CODE OF 1954, §§ 264(a), 265(1).
37. Ernest J. Keefe, 15 T.C. 947 (1950); Josephy Nussbaum, 19 B.T.A. 949 (1928).
38. INT. REV. CODE OF 1954, § 101(a)(1).
39. INT. REV. CODE OF 1954, § 101(a)(2).
40. INT. REV. CODE OF 1954, § 101(a)(2)(B).
41. David A. Foxman, 41 T.C. 535 (1964), holding that there was a sale under § 741, rather than a liquidation under § 736, because the remaining partners had obligated themselves as individauls to purchase the other partner's interest, because the partnership was not obligated to the partner who was leaving, because part of the consideration was assets not belonging to the partnership and because throughout the agreement the transaction was referred to as a sale rather than a liquidation of the partner's interest; Charles F. Phillips, 40 T.C. 157 (1963), where the Tax Court held that there was a sale and not a liquidation because the agreement was between partners and not with the partnership; Fitzgerald Atkinson, 23 CCH Tax Ct. Mem. 834 (1964), wherein the court found that the partners clearly intended a sale of the partner's interest notwithstanding the withdrawal provisions of the partnership agreement; William T. Wheeling, 23 CCH Tax Ct. Mem. 778 (1964), wherein the Tax Court ruled that the intent of Congress was to allow the partners to determine whether the transfer would be a "sale" under § 741 or a "liquidation" under § 736.

the surviving partner or the partnership; and (2) the intent of the partners at the time of the making of the partnership agreement.

A partner's interest in a partnership is a capital asset and its sale constitutes the sale of a capital asset.[42] However, any amount attributable to the deceased partner's interest in "unrealized receivables"[43] (generally for a cash basis taxpayer these would be accounts receivable arising from the sale of goods and services) or "substantially appreciated inventory"[44] shall be considered as an amount realized from the sale of property other than a capital asset,[45] and therefore gain on such items would be ordinary income.

If the insurance proceeds from a policy on the life of a partner, which the partner owned and on which he paid the premiums, are paid directly to his wife, estate or other beneficiary by the insurance company, the *Paul Legallet* case[46] holds that although the insurance proceeds were to be applied toward the purchase price of the deceased partner's interest, their use for this purpose will not increase the surviving partner's basis in the partnership. Knowledgeable counsel can avoid this possible pitfall by making certain that the proceeds are paid to the surviving partner rather than directly to the wife or estate of the insured.

Although it is not necessary to consider future adjustments to the basis of the partnership in specific partnership assets at the time of planning the partnership agreement, discussion of the problem will give a complete picture of what happens after a partner's death. The partnership may elect to adjust its basis in partnership property[47] whenever there has been a transfer of a partnership interest, either by sale or exchange or on the death of a partner. The amount of the adjustment will be the difference between the fair market value of the transferor partner's interest as determined by the partnership agreement and the adjusted basis of the partnership in that partner's proportionate part of the partnership property.[48] The allocation of basis among partnership properties shall be made in accordance with the rules provided by the Commissioner.[49]

B. *Tax Considerations Under the Entity Plan*

1. Estate Tax

Under a properly executed entity plan the partnership owns the policies on the lives of the partners. The deceased partner has none of the "incidents of

42. INT. REV. CODE OF 1954, § 741; Rev. Rul. 59-109, 1959-1 CUM. BULL. 168.
43. INT. REV. CODE OF 1954, § 751(c).
44. INT. REV. CODE OF 1954, § 751(d).
45. INT. REV. CODE OF 1954, § 751(a).
46. 41 B.T.A. 294 (1940).
47. INT. REV. CODE OF 1954, § 754.
48. INT. REV. CODE OF 1954, § 743.
Example: A three-man partnership with a total fair market value of $60,000 and total adjusted basis of $30,000 will be allowed a $10,000 increase in the basis of the partnership property if the deceased partner's estate is paid $20,000 for his interest. Treas. Reg. § 1.743-1(b)(2) (1956).
49. INT. REV. CODE OF 1954, §§ 743(c), 755.

ownership"[50] and therefore the proceeds from the policy are not included in his gross estate.[51] But the value of the deceased partner's interest in the partnership as determined by the agreement will be included in his gross estate.[52]

> The representative of a deceased partner does not succeed to any right to specific partnership property. In substance the deceased partner's interest, to which his representative succeeds, is a chose in action, a right to receive in cash the sum of money shown to be due him upon liquidation and accounting. These substantive results may be rationalized upupon a theory of the partnership "entity."[53]

If there is a deviation from the entity plan so that the proceeds are paid to the estate of the deceased partner, or to his wife, or the partner has the right to designate the beneficiary of the policy on his life, then the arrangement may subject the estate to an inclusion of both the insurance proceeds and the value of the partnership interest. However, the Commissioner has indicated[54] and the cases hold[55] that there shall not be a double inclusion where the partnership agreement provides that the proceeds are in partial or full payment for the deceased partner's interest.

If the partnership owns the policies, the proceeds will be an asset of the partnership and the agreement should include specific provisions on how the insurance proceeds should be handled.[56] The Commissioner has indicated that these proceeds will be considered as a partnership asset for the purpose of "determining whether the agreement was supported by full and adequate consideration in money or money's worth."[57] Therefore, the deceased partner's gross estate may be larger under the entity plan than under the cross purchase plan, because under the latter only the value of the partnership interest of the deceased partner, exclusive of the insurance proceeds, is included in his gross estate.

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50. INT. REV. CODE OF 1954, § 2042.
51. Estate of Frank H. Knipp, 25 T.C. 153 (1955), *nonacq.*, (as to inclusion of insurance proceeds in gross estate) 1956-2 CUM. BULL. 10, *aff'd*, 244 F.2d 436 (4th Cir. 1957), *cert. denied*, 355 U.S. 827 (1957); Estate of George Atkins, 2 T.C. 332 (1943); Lawthers, *Business Buy-Out Agreements with Life Insurance Under the New Code*, 9 J. AM. SOC'Y OF C.L.U. 73, 76 (1954). *But cf.* Commissioner v. Estate of Karagheusian, 233 F.2d 197 (2d Cir. 1956).
52. INT. REV. CODE OF 1954, § 2042.
53. McClennen v. Commissioner, 131 F.2d 165, 167 (1st Cir. 1942). See also Dohan, *Income in Respect of a Deceased Partner*, N.Y.U. 19TH INST. ON FED. TAX 337, 343 (1961).
54. Proposed Treas. Reg. § 20.2042-1(c)(6), 21 Fed. Reg. 7886 (1956); Memorandum for the Press, *supra* note 35; Special Ruling, September 22, 1947.
55. Estate of Ray E. Tompkins, 13 T.C. 1054 (1949), *acq.*, 1950-1 CUM. BULL. 5; M. W. Dobrzensky, 34 B.T.A. 305 (1936), *nonacq.*, XV-2 CUM. BULL. 39; Boston Safe Deposit & Trust Co., 30 B.T.A. 679 (1934). *Cf.* Estate of G. C. Ealy, 10 CCH Tax Ct. Mem. 431 (1951).
56. The usual method is to treat the cash surrender value as an asset and provide that any amount in excess of the cash surrender value which is paid by virtue of a partner's death shall not be included in computing book value. This has further significance because of its affect on the surviving partner's basis in his partnership interest. See text accompanying note 89 *infra*.
57. Proposed Treas. Reg. § 20.2042-1(c)(6), 21 Fed. Reg. 7886 (1956).

However, the Court of Appeals for the Seventh Circuit[58] has indicated that when the proceeds of insurance policies on the life of the president of a corporation, payable to the corporation, are included in valuing the decedent's shares, there should be a reduction in the value of the shares because of the death of the corporation's guiding spirit. The same principle should be applicable in a partnership, thereby allowing a reduction in the total value of the partnership, because of the loss of the partnership's guiding spirit.

2. Income Tax

Payments made by a partnership to a partner for his entire interest in the partnership are called a liquidation of the partner's interest and are governed by section 736 of the Code. Section 736 only applies to payments made by the partnership and not to transactions between partners.[59] Section 736 payments[60] can be divided into three tiers.[61]

Tier One Payments are for the fair market value of the deceased partner's interest in the partnership property.[62] These payments are treated as distributions of partnership property—a capital transaction giving rise to capital gains or losses.[63] The estate of the deceased partner would have no capital gain because its basis in the partnership would be the fair market value at the time of death, which would be the amount provided in the partnership agreement.[64]

However, payments made by the partnership in liquidation of the deceased partner's interest in "unrealized receivables"[65] shall not be considered a distribution by the partnership.[66] Instead, they are considered as Tier Three Payments which are ordinary income payments.

Although the Code does not expressly provide that payments for the deceased partner's interest in "substantially appreciated inventory"[67] shall be excluded from Tier One Payments, the Regulations provide that such payments shall be subject to ordinary income treatment.[68]

Tier Two Payments are those made by the partnership for the deceased partner's interest in good will. Such payments are ordinary income payments "except to the extent that the partnership agreement provides for a payment with respect to good will."[69] The agreement must make a specific provision with respect

58. Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933).
59. Treas. Reg. § 1.736(a)(1)(i) (1956).
60. The following discussion assumes that the payments are in cash.
61. This terminology is borrowed from WILLIS, HANDBOOK OF PARTNERSHIP TAXATION (1957).
62. INT. REV. CODE OF 1954, § 736(b).
63. INT. REV. CODE OF 1954, § 731.
64. INT. REV. CODE OF 1954, §§ 742, 1014.
65. INT. REV. CODE OF 1954, § 751(c).
66. INT. REV. CODE OF 1954, § 736(b)(2)(A).
67. INT. REV. CODE OF 1954, § 751(d).
68. Treas. Reg. § 1.736-1(b)(4) (1956).
69. INT. REV CODE OF 1954, § 736(b)(2)(B).
But see Jackson Investment Co., 41 T.C. 675 (1964), where there was no provision in the articles of partnership with respect to good will, but later the

to good will and "an intent to compensate for good will [can not] be drawn from the surrounding circumstances. . . ."[70]

In the *V. Zay Smith* case[71] the Tax Court held that the amount a retiring partner received in excess of his basis in the partnership would be ordinary income and not capital gains where the partnership agreement provided that the value of the partner's interest was to be determined by book value plus a premium, but that no value was to be assigned to good will. The Tax Court reasoned that Congress had specified the method by which the partners could secure capital gains treatment of payments for good will and that Congress specifically excluded any other method, such as inferences drawn from the surrounding circumstances. Nevertheless if it is desired that payments for good will be ordinary income, the partnership agreement should expressly provide that no payments are made for good will and thereby avoid litigation. Furthermore, if an ordinary income transaction is desired, the partnership agreement should specifically designate the entire payment in excess of the fair market value of the partner's interest in tangible assets as a Tier Three Payment. This avoids later claims by the estate that the payments were for intangible assets other than good will such as patents, secret processes, trademarks, franchises, customers list, or trade secrets.

The Regulations[72] provide that only "reasonable" payments for good will can receive capital gains treatment.

> Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by formula, shall be regarded as correct.[73]

The Commissioner's latest position with respect to good will in a professional business is that:

> [T]he extent to which the proceeds of sale can be allocated to goodwill will be determined on the facts rather than by whether the business is, or is not, dependent solely upon the professional skill or other personal characteristics of the owner.[74]

If the partnership agreement provides for a reasonable payment for the deceased partner's interest in the partnership good will, there would be no income tax payable by the estate, since the basis of the good will would be equal to the valuation placed on it in the agreement. However, if there is a payment made for good will but it is not expressly denominated as such in the partnership agreement, then it will be a Tier Three Payment and therefore ordinary income to the estate.

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partners and partnership executed an agreement entitled "Amendment of Limited Partnership Agreement of George W. Carter Company" in which part of the payment for a retiring partner's interest was referred to in the agreement as "a guaranteed payment, or a payment for good will." The Tax Court held the payments were not for good will.

70. Smith v. Commissioner, 313 F.2d 16, 19 (10th Cir. 1962).
71. 37 T.C. 1033 (1962), *aff'd*, 313 F.2d 16 (10th Cir. 1962).
72. Treas. Reg. § 1.736-1(b)(3) (1956).
73. Treas. Reg. § 1.736-1(b)(3) (1956).
74. Rev. Rul. 64-235, 1964 INT. REV. BULL. No. 35, at 9.

If the partnership has a basis in the partnership good will, then to the extent of that basis the good will is treated as any other partnership asset and payments for it would be Tier One Payments.[75]

Tier Three Payments are all those payments made by the partnership to a deceased partner which are in excess of the fair market value of the deceased partner's interest in the partnership assets plus, if the partnership agreement so provides, a reasonable amount for good will. These payments are covered by section 736(a) and are called either a "distributive share"[76] of partnership income or a "guaranteed payment."[77]

A "distributive share" is an amount determined with reference to the income of the partnership, such as a payment of ten percent of the partnership income for a period of five years. A "guaranteed payment" is an amount determined without reference to the partnership income such as a payment of $15,000 a year for five years.[78]

The estate reports Tier Three Payments as "income in respect of a decedent"[79] and the payments

> shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment.[80]

Whenever a partner dies, there is at least the possibility of a bunching of more than one year's partnership income into one year. This can be avoided if the proper provisions are made in the partnership agreement.[81]

The Code allows the partners considerable freedom under the entity plan to determine how the tax burden shall fall after the death of a partner.[82] The partnership agreement can provide for a capital transaction in which event the estate pays no income tax but the surviving partner receives no deduction for

75. Treas. Reg. § 1.736-1(b)(3) (1956).
76. INT. REV. CODE OF 1954, § 736(a)(1).
77. INT. REV. CODE OF 1954, § 736(a)(2).
78. INT. REV. CODE OF 1954, § 707(c).
In F.A. Falconer, 40 T.C. 1011 (1963), *acq.,* 1964 INT. REV. BULL. No. 18, at 6, the court held that there were "guaranteed payments" where each partner was to receive a salary of $150 per week from the partnership as compensation for services rendered, and where such amount was subject to change only by mutual agreement of the partners, and where the salaries were to be considered as a part of the operating expenses of the business. The court said, "[T]he touchstone for determining 'guaranteed payments' is whether they are payable without regard to partnership income." F. A. Falconer, *supra* at 1015. Also see Foster v. United States, 329 F.2d 717 (2d Cir. 1964).
79. INT. REV. CODE OF 1954, §§ 753, 691.
80. Treas. Reg. § 1.736-1(a)(5) (1956).
81. See Bakst, *Payments to a Retiring Partner or to a Deceased Partner's Successor in Interest, November 11, 1960,* N.Y.U. 19TH INST. ON FED. TAX 319, 328-31 (1961); Dye, *Tax Problems in the Administration of an Estate,* 20 OHIO ST. L.J. 1, 7-9 (1958); Effer, *Sales of Partnership Interests and Death or Retirement of Partner,* N.Y.U. 15TH INST. ON FED. TAX 122-25 (1957).
82. INT. REV. CODE OF 1954, § 736.

the payments.[83] On the other hand, the partnership agreement can provide for payment of a "distributive share" or "guaranteed payments" to the estate, resulting in a transaction in which the estate receives ordinary income, but the surviving partner's distributive share of partnership income is reduced by the amount of such payments.[84]

The Commssioner has set out the procedure for allocating payments received during the year by the estate between those for the deceased partner's interest in the partnership and those which are "income in respect of a decedent." The surviving partner and the estate are allowed to allocate the payments, provided the total amount allocated to Tier One Payments "does not exceed the fair market value of such property at the date of death. . . ."[85]

The right of the partnership to elect to adjust its basis is the same under the entity plan as it is under the cross purchase plan.

The basis of the surviving partner's interest in the partnership is increased by his proportionate part of the premiums paid for insurance owned by the partnership[86] if the premiums are taxable income of the partnership invested in a partnership asset.[87] The partnership will not be allowed a deduction for income tax purposes for the payment of premiums.[88]

Furthermore, the basis of a partner is increased by his proportionate part of the insurance proceeds which exceed paid premiums.[89] To secure the full benefit of this tax free increase in basis, the partnership agreement should provide that the deceased partner has no interest in the excess of the policy proceeds over the cash surrender value, thereby giving the full basis increase from the insurance proceeds to the surviving partner while the estate's basis in the deceased partner's interest is increased by section 1014.

Willis has pointed out a loophole in the law with respect to the estate's basis in the partnership interest.[90] When a partner dies his estate's basis in the property will be the "fair market value of the property at the date of the decedent's death."[91] The property in the hands of the estate is the partnership interest, a chose in action,[92] including the deceased partner's proportionate part in "unrealized receivables." If the value of the deceased partner's interest is

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83. Treas. Reg. § 1.736-1(a)(2) (1956).
84. Treas. Reg. § 1.736-1(a)(4) (1956).
85. Treas. Reg. § 1.736-1(b)(5) (1956).
86. Treas. Reg. § 1.705-1(a)(2)(i) (1956).
87. "However, each partner's net increase in basis resulting from each payment may be limited to his share of the increment in cash surrender value resulting from the payment, on the theory that only that portion of the partnership expenditure is 'properly chargeable to capital account' within the meaning of section 705(a)(2)(B), the excess being a nondeductible current expense. Thus, if term insurance is utilized to fund the agreement, there may be no net increase in basis, since there will be no cash surrender value in the policy." Note, 71 HARV. L. REV. 687, 699-700 n.73 (1958).
88. INT. REV. CODE OF 1954, §§ 264(a), 265(1); Clarence W. McKay, 10 B.T.A. 949 (1928).
89. INT. REV. CODE OF 1954, § 705(a)(1)(B).
90. WILLIS, HANDBOOK ON PARTNERSHIP TAXATION 391-95 (1957).
91. INT. REV. CODE OF 1954, §§ 1014, 742.
92. See text accompanying note 53 *supra*.

composed of $5,000 of "unrealized receivables" and $3,000 of other property, the basis of the partnership interest would be $8,000. However, when the $8,000 is paid to the estate for the partnership interest, $5,000 of it would be considered as ordinary income because it was for an interest in "unrealized receivables."[93] The remaining $3,000 would be a distribution by the partnership for the interest of the decedent,[94] but since there is an $8,000 basis in the partnership interest, arguably the estate would be entitled to a $5,000 deductible loss.[95]

This loophole was obviously not intended by Congress. Rather it seems that Congress intended that those payments which qualified as capital transactions would be the basis of the partnership interest, and that ordinary income transactions, including payments for "unrealized receivables" and good will not provided for in the partnership agreement, would not affect the estate's basis in the partnership interest. This entire problem would be solved if the property, the partnership interest, were classified as "income in respect of a decedent."[96] However, the property which acquires a basis is the partnership interest and not the deceased partner's proportionate part of the various partnership properties. Nevertheless, the Commissioner has apparently taken the position that the estate's basis must be reduced by amounts which do not qualify for capital gains treatment:

> [T]he basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent. . . .[97]

The fair market value of the partnership interest would be the total amount received by the estate under the partnership agreement reduced by Tier Three Payments because they are considered "income in respect of a decedent."[98]

The partnership agreement could provide that the partners carry the insurance on each other but that the partnership would liquidate the deceased partner's interest. Then when a partner died, the proceeds from the insurance policy would be donated by the surviving partner as a capital contribution to the partnership. The partnership then would liquidate the deceased partner's interest with these proceeds. The Commissioner might collapse this arrangement under the "step transaction" theory and consider the payments as coming directly from the surviving partner. However, there seems to be no reason why he should take such a course of action when it is obvious that the purpose of the sections on partnership taxation is to give considerable latitude to the partners in determining whether payments for the partnership interest shall be capital or ordinary income transactions.

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93. INT. REV. CODE OF 1954, § 736(b)(2)(A).
94. INT. REV. CODE OF 1954, § 736(b).
95. INT. REV. CODE OF 1954, § 731(a)(2).
96. INT. REV. CODE OF 1954, § 1014(c).
97. Treas. Reg. § 1.742-1 (1956).
98. INT. REV. CODE OF 1954, § 753.

Under the above variation of the entity plan the partnership would not own the insurance policies and therefore the value of the partnership interest would be less than under the usual entity plan. Therefore, lower valuation could be placed on the deceased partner's interest in partnership property without being subject to attack by the Commissioner. Consequently this variation might allow a larger portion of the liquidation of the deceased partner's interest to be an ordinary income transaction. However, this variation gives the deceased partner less security because the surviving partner is not directly bound to pay; and if the surviving partner is contractually bound, the Commissioner may be more likely to collapse the arrangement and say that in substance the partnership owns the policies.

The importance of the partnership agreement can be seen throughout the operation of the entity plan. It is possible for the partners to decide whether the payments for a deceased partner's interest will be an ordinary income or a capital transaction.[99] The decision can be made even after the death of a partner. The partnership agreement may provide for an amendment if all surviving partners and the estate are agreeable. The amendment of the agreement must be made before "the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions). . . ."[100] The fact that the partnership agreement can be amended should not cause the partners to avoid careful consideration of whether to provide for an ordinary income or capital transaction because after death the surviving partner and the estate may not be able to agree.

C. *Tax Considerations Under the Trust Plan*

1. Estate Tax

Partners can take out policies on the life of each other and assign them to the trust, or the partnership can take out the policies and assign them to the trust. Under neither of these arrangements would any partner have any "incidents of ownership," if under the trust the partner has no control with respect to the policy on his life.[101] The trust could be funded so that it could pay the premiums, or the premiums could come from the partners or the partnership.

The Commissioner has indicated that if the partnership either creates a trust for its insurance policies or if the partners create a trust for the insurance policies naming the partnership as beneficiary, the proceeds of the insurance policies shall be considered an asset of the partnership for purposes of determining whether the partnership agreement is supported "by full and adequate consideration" and was "entered into in good faith and at arm's length."[102]

The value of the deceased partner's interest in the partnership is included

99. For a discussion of the circumstances under which an income transaction would be desirable see Snyder, *Cross-Purchase vs. Entity Buyouts for Partnerships —Capital Transaction or Ordinary Income*, 17 J. Am. Soc'y C.L.U. 203, 209-10 (1963).
100. Int. Rev. Code of 1954, § 761(c).
101. Treas. Reg. § 20.2042-1(c)(4) (1958).
102. Proposed Treas. Reg. § 2042-1(c)(6), 21 Fed. Reg. 7886 (1956).

in his gross estate.[103] Since the disposition of the partnership interest is restricted in the same manner by the partnership agreement whether or not a trust is used, it is presumed that the valuation of the interest by the partnership agreement will be fixed for estate tax purposes.[104] Similarly there should not be a double inclusion of the insurance proceeds and the partnership interest, if the cross purchase or entity arrangement with a trust is not strictly followed.

2. Income Tax

If the trust agreement provides that the trustee shall receive the proceeds of the policy for or on behalf of the surviving partner and upon receipt from the deceased partner's estate shall distribute the deceased partner's interest to the surviving partner and the insurance proceeds to the estate, this should result in exactly the same income tax consequences as under the cross purchase plan.

If the trust agreement provides that the trustee shall receive the proceeds for or on behalf of the partnership and that upon receipt of the deceased partner's interest from the estate, the trustee shall transfer the interest to the partnership, the transaction might be construed as a sale of the partnership interest, rather than a liquidation, and therefore be subject to the same treatment as under the cross purchase plan. However, a better view would be that the payment by the trustee should be considered a payment by the partnership in liquidation of the deceased partner's interest.[105] If the Commissioner considers the proceeds held by the trust as an asset of the partnership in determining whether the partnership agreement is supported by "full and adequate consideration," then it is consistent to consider the payment from the trustee as being a payment by the partnership.

IV. Other Considerations

A. *The Proceeds of the Life Insurance Should be Included in Computing the Value of the Partnership Interest.*[106]

The partnership agreement will not be fair to the deceased partner unless the proceeds from the policy on his life are taken into account in arriving at the value of his partnership interest. If the business is worth $100,000 and partners A and B each purchase a $50,000 insurance policy on the other partner (cross purchase plan), when A dies, B receives $50,000 and pays it over to A's estate. A's estate has $50,000 and B has a $100,000 business. If A had not entered into a cross purchase plan, but instead had spent his money on a policy on his life, he would have spent no more money and yet his estate would have $50,000 and a half interest in the partnership.

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103. Int. Rev. Code of 1954, § 2033.
104. *Cf.* Estate of Henry A. Maddock, 16 T.C. 324 (1951), *acq.*, 1951-2 Cum. Bull.
105. Int. Rev. Code of 1954, § 736.
106. See generally, Neuhoff, *Life Insurance Funding of Business Buy-Out Agreements*, 25 Mo. L. Rev. 3, 6-13 (1960).

If the entity plan is used then the proceeds of the insurance policy should also be taken into account because although the partnership owns the policies, the expenditures for the premiums are actually made by the partners. The estate would have more if the partnership had not purchased any insurance, or if each partner had taken out a policy on his own life.

Although the proceeds should be taken into account in computing the value of the partnership interest, it must be remembered that for income tax reasons the deceased partner should not have any interest in the proceeds of the policy.[107]

B. *How Much Insurance Should be Carried*[108]

If the assertion in the previous section is accepted—that the proceeds of the insurance policy should be included in computing the value of the deceased partner's interest—then the formula for computing how much life insurance is needed to fund the partnership agreement in full, assuming no cash surrender value, is as follows:

$$x = \frac{b}{n-1}$$

where b is the value of the business (exclusive of the insurance proceeds), n is the number of partners and x is the amount of insurance needed. Applying this formula to a two-man partnership worth $100,000, each partner should be insured for $100,000. When A dies his estate will recieve $100,000 and B will have a $100,000 business.

The formula for computing the amount of insurance needed becomes much more complicated when cash surrender value enters the picture. Assuming that the partnership owns the policies, when A dies, B has a $100,000 business and the cash surrender value of the policy which the partnership holds on his life. Therefore, whenever a policy with cash surrender value is used, it is necessary to also insure the cash surrender value as it increases. This will increase the cost of funding the partnership agreement.[109]

The partnership agreement could provide that the cash surrender value of the policies on the life of the survivor be applied toward the purchase of the deceased partner's interest. As time passes and the cash surrender value on the policies increases, the face amount of the insurance could be lowered, thereby keeping the same dollar amount available for payment; or the face amount could be left the same and as the cash surrender value increases the dollar amount available for payment would increase. However, if there are more than two partners,

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107. See text accompanying note 89 *supra*.
108. Neuhoff, *supra* note 106, at 13-33.
109. Neuhoff, *supra* note 106, at 16-20 shows that if two partners, age 35, with a $100,000 business, enter into a partnership agreement which is fully funded with ordinary life insurance and the cash surrender value is not used to pay for the deceased partner's interest, when the partners reach age 65 the partnership would have to carry life insurance totaling $345,490.76 (over seven times the worth of each partner's interest at the time of entering into the agreement) and this assumes that the worth of the partnership, exclusive of life insurance policies, is still $100,000.

it is probable that the remaining partners will want to keep a funded partnership agreement in effect and therefore the cash surrender value of the policies held by the partnership will not be available to pay for the deceased partner's interest. If the cross purchase plan is used, cash surrender value will usually be available.

C. *What Kind of Insurance Should be Used to Fund the Partnership Agreement*

Any kind of life insurance can be used to fund the partnership agreement. The type which should be used will depend in large part upon the financial circumstances of the partnership and the possible uses of the life insurance in addition to merely funding the agreement. If it is desired that the life insurance policies not only provide protection in the event of death, but also provide funds for eventual retirement of the partners, then some form of ordinary life or endowment policy should be used. Such policies cost more than term insurance, which merely provides protection in event of death.

If the entity plan is used there is one additional type of insurance policy which is available in the case of a two-man partnership.[110] The partnership could purchase a joint-life policy, payable only when the first of two insured partners dies. One joint ordinary life policy costs less than two ordinary life policies,[111] but there is less cash surrender value and such a policy could not be transferred to individuals later in the event of dissolution.

D. *Multiple Partners*

The standard cross purchase plan becomes cumbersome when there are several partners, because each partner must have a policy on the life of every other partner for his proportionate share of the insured partner's interest. If there are five partners, each partner will have four insurance policies, one on each of the other partners, making a total of twenty policies, whereas under the entity plan there would only be five policies.

The number of policies needed to fund the agreement in full can become even more confusing after one or more of the partners has died. If there are only three partners and the business is worth $100,000, applying the formula,[112] each partner should be insured for $50,000. Therefore, each partner will carry a policy on the life of the other two partners for $25,000. When one partner dies, each of the surviving partners will pay his estate $25,000. The estate will still have insurance policies on the lives of the surviving partners and a common course of

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110. There is no actuarial reason why such a policy could not be devised where there are more than two partners.

111. According to New York Life Insurance Corporation rates, one joint-life policy on two partners, both 35, for $100,000 would cost $3,213 annually, while two policies, one on each partner for $100,000 would each cost $2,284 annually, or a total of $4,568 a year. There would be a premium saving in such a situation of $1,355 per year.

112. $x = \frac{b}{n-1}$ where b is the value of the business, n is the number of partners, and x is the amount of insurance needed.

action is for the surviving partners to buy the policy on each other from the estate for the cash surrender value. This means that each of the two surviving partners would now have $50,000 worth of insurance on the other surviving partner.

The partnership situation has changed however; now there are only two partners. Applying the formula, each of the surviving partners should be insured for $100,000. This requires the acquisition of an additional policy for $50,000 on each partner to fund the agreement in full. Under such an arrangement, each partner would have three policies: the original one for $25,000 bought when there were three partners; a second policy for $25,000 procured from the estate of the deceased partner; and a third policy for $50,000 purchased after the death of the partner.

This difficulty under the cross purchase plan can be eliminated by having the partners own the policies as joint tenants with a right of survivorship; that is, the policy on A is owned by BCD and the policy on B is owned by ACD, etc. The Code seems to do away with any fear of the "transferee for value rule" which might have previously arisen out of such an arrangement.[113] A new partner entering the partnership would necessitate changes in the legal ownership of the jointly held policies.[114] Furthermore, if there is any cash surrender value it should be taken into account in valuing the deceased partner's interest.

The entity plan may be easier to administer than the cross purchase plan because of the possibility that fewer insurance policies will be needed. Also, if there are fewer policies, the total cost of procurement will be less; and because the policies will be in larger amounts, the premiums will be less than under the cross purchase plan where there are a larger number of smaller policies.

E. *Surveillance Under the Cross Purchase Plan*

So that the partners may be assured that the agreement is being properly funded under the cross purchase plan, the partnership agreement should provide either that the premium payments are to be made by the partnership and charged to the respective partners as salary or that each partner furnish evidence of the payment of the premiums and authorize the insurance companies to provide information about the policies upon request by the other partners.

F. *Partners with Unequal Shares*

Under the entity plan each partner is actually paying premiums in proportion to his partnership interest, which means in effect that he is providing the funds for the survivor to purchase his interest. Therefore if A owns 75 per cent of the partnership and B owns 25 per cent, A is paying 75 per cent of the premiums but would only need to purchase 25 per cent of the business if B should die. Consequently if the entity plan is used, adjustments should be made in the partner's distributive share of the partnership income to allocate properly the cost of the

113. INT. REV. CODE OF 1954, § 101(a)(2).
114. See generally, Lawthers, *Business Buy-Out Agreements with Life Insurance Under the New Code,* 9 J. AM. SOC'Y OF C.L.U. 73, 74 (1954).

funding. This would cause the partner with the larger distributive share to get a still larger distributive share of the partnership income and assuming that he is in a higher tax bracket than the smaller partner, the cost in terms of after-tax income would be higher under the entity plan than under the cross purchase plan.

However, under the cross purchase plan the smaller partner is going to have to purchase insurance equal to the larger partner's share in the business. This may place an exceedingly heavy burden on a smaller partner. However, this burden could be lightened by providing for an intentional increase in the distributive share of partnership income to the minority partner.[115] This would assist the smaller partner to meet his relatively higher obligations under the cross purchase plan and would cause the funds which will provide the premiums to come from a lower tax bracket.

G. *Rights of Creditors*

If the surviving partner is the beneficiary of the policy, the proceeds may be tied up by his creditors before the money can be distributed to the estate. There is also the possibility that the survivor will disappear when the insurance proceeds substantially enhance his financial situation. These disastrous results can be avoided by having the proceeds paid directly to the estate. But then the surviving partner may be relegated to the position of a general creditor of the estate if it should happen to be insolvent.[116] The use of a trust will probably alleviate these problems.

V. Conclusion

Careful consideration should be given to drafting a complete partnership agreement to take care of events which occur on the death of a partner. The valuation of the partner's interest can be fixed in the agreement so there is little likelihood of dispute or litigation either with the deceased partner's estate or with the Commissioner of Internal Revenue. If the partnership agreement is funded in full, the partnership will be spared the strain of having a deceased partner's estate or his wife and family as a partner. Proper use of a trustee can avoid numerous complications. Although all of these promised joys may not be forthcoming, it is certain that none will come about if lawyers, like mice, do not lay schemes.

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115. Snyder, *Cross Purchase vs. Entity Buyouts for Partnership, Capital Transaction or Ordinary Income?*, 17 J. AM. SOC'Y OF C.L.U. 203, 205 (1963).
116. WILLIS, HANDBOOK ON PARTNERSHIP TAXATION 420-22 (1957); Cavanaugh, *The Entity Type of Partnership Purchase and Sale Agreement*, 8 J. AM. SOC'Y C.L.U. 41, 48 (1953).